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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1214

STRATHMORE SECURITIES, INC., AND AULDUS H. TURNER, JR., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The court of appeals issued no opinion. The opinion (J.A. 256–268) of the Securities and Exchange Commission is unreported.

JURISDICTION

The judgment of the court of appeals (Pet. App. 26) was entered on January 3, 1967. The petition for a writ of certiorari was filed on April 3, 1967. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND RULES INVOLVED

The pertinent provisions of Section 15A of the Securities Exchange Act of 1934 as amended, 15 U.S.C. 78*o*–3, and the Rules of Fair Practice of the National Association of Securities Dealers are set forth in Pet. App. B.

QUESTIONS PRESENTED

1. Whether petitioners were denied due process of law in proceedings before the National Association of Securities Dealers and the Securities and Exchange Commission.

2. Whether the Securities and Exchange Commission properly sustained the findings of the National Association of Securities Dealers that petitioners had violated the rules of the association by selling securities to customers at unfair prices and by extending credit improperly.

STATEMENT

Petitioner Strathmore Securities, Inc. ("Strathmore") is a member of the National Association of Securities Dealers ("NASD"), a securities association registered under Section 15A of the Securities Exchange Act of 1934. Petitioner Auldus H. Turner, Jr. ("Turner") is a vice president of Strathmore and is registered with the NASD as a representative of Strathmore.

Subsection (b)(8) of Section 15A, 15 U.S.C. 78*o*–3(b)(8), requires that a registered association must have rules designed, *inter alia,*

> * * * to prevent fraudulent and manipulative acts and practices, to promote just and

> equitable principles of trade, to provide safeguards against unreasonable profits or unreasonable rates of commissions or other charges, and, in general, to protect investors and the public interest, and to remove impediments to and perfect the mechanism of a free and open market * * *.

Accordingly, the NASD has adopted Rules of Fair Practice. One of these rules (Articles III, Section 1) requires members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade; another (Article III, Section 4) provides that, whenever a member sells for his own account to his customer, the price must be fair, taking into consideration all relevant circumstances including market conditions, the expense involved and the fact that the member is entitled to a profit. In its interpretation of these rules the NASD has stated that its members are prohibited from entering "into any transaction with a customer in any security at a price not reasonably related to the current market price" and that, in the absence of special circumstances, a mark-up of more than five percent above the current market price is unreasonable.[1]

Disciplinary proceedings against petitioners for alleged violation of these rules in connection with sales in October 1962 and February 1963 and improper extensions of credit (J.A. 14–22) were instituted pursuant to rules of the NASD required by Section 15A

[1] For an explanation of the NASD "five per cent policy," see NASD Manual, G–1 to G–3.

(b) (9) and (10), of the Act, 15 U.S.C. 78*o*–3(b) (9) and (10).[2] These proceedings began wiith a complaint filed on May 16, 1963, by the local District Committee of the NASD which named petitioners and several other persons, and to which petitioners filed an answer (J.A. 23–42). After a hearing (J.A. 42–154) the District Committee issued a decision (J.A. 155–171) finding that petitioners had committed the violations alleged. Specifically, the District Committee found that petitioners (1) had sold stock of Unison Electronics Corp. (Unison) and National Bowling Lanes, Inc. (National) at prices which were unfair in view of all relevant circumstances, and (2) had failed to comply with Sections 4(c)(2) and 4(c)(8) of Regulation T of the Board of Governors of the Federal Reserve System.[3] The District Committee fined Strathmore $1,000 and expelled it from membership in the Association, and fined Turner $1,000 and revoked his registration. On appeal to the Board of Governors of the NASD, the decision of the District Committee was affirmed as to petitioners.

Upon an independent review of the record by the Securities and Exchange Commission, pursuant to Section 15A (g) and (h), 15 U.S.C. 78*o*–3 (g) and

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[2] Those subsections state that the rules of a registered association must "provide that its members and persons associated witih its members shall be appropriately disciplined, by expulsion, suspension, fine, censure * * * or any other fitting penalty, for any violation of its rules" and "provide a fair and orderly procedure with respect to the disciplining of members and persons associated with members * * *."

[3] The latter violation, involving the improper extension of credit to purchasers of securities, has never been contested by petitioners.

(h), the Commission concluded that petitioners "effected sales at unfair prices at least in 11 transactions in Unison stock and in 35 transactions in National stock, and thereby violated Sections 1 and 4 of Article III of the NASD's rules" (J.A. 265).[4] Because the Commission disagreed with certain NASD findings against the petitioners[5] it reduced the sanctions of expulsion and revocation to 90-day suspensions (J.A. 267–268) but otherwise affirmed the decision of the NASD (J.A. 265–267). The court of appeals affirmed the Commission's decision by a *per curiam* judgment without opinion.

ARGUMENT

1. Petitioners' due process contentions are without merit and have been uniformly rejected, including the contentions that the delegation of power to the NASD is unconstitutional,[6] that the NASD's mark-up policy

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[4] In 11 of these transactions, petitioners' mark-up over their contemporaneous cost was more than 15 percent; in the other 35 it was 13 percent or more (J.A. 260–261). These facts were undisputed.

[5] As to a block of 8,340 shares of Unison stock which had been picked up at a distressed price of $.90 a share, the Commission did not agree with the NASD findings that the resales of these shares in numerous smaller transactions at a mark-up of about 81 percent "were at unfair prices" (J.A. 259–260). On the contrary, the Commission "concluded that the most aggravated charges, of mark-ups of about 81% in the sale of Unison stock, are not supported by the record" (J.A. 267). Notwithstanding this express rejection of the NASD position on these transactions, the petitioners are still relying upon that position as a basis for obtaining review by this Court (Pet. 14, 15).

[6] *R. H. Johnson & Co.* v. *Securities and Exchange Commission*, 198 F. 2d 690, 695 (C.A. 2), certiorari denied, 344 U.S.

is vague and fails to provide adequate standards,[7] that because the NASD lacks subpoena power it is difficult for respondents to obtain evidence necessary to adequately present their case,[8] and that a fair hearing is denied because the District Committee, which decides the case in the first instance, also issues the complaint and is made up of the respondents' competitors.[9] Equally without merit are the conten-

855; *Nassau Securities Service* v. *Securities and Exchange Commission*, 348 F. 2d 133 (C.A. 2).

[7] *Handley Investment Co.* v. *Securities and Exchange Commission*, 354 F. 2d 64 (C.A. 10); *Midland Securities, Inc.*, 40 S.E.C. 333; *Boren & Co. et al.*, 40 S.E.C. 217; *National Association of Securities Dealers, Inc.*, 17 S.E.C. 459; *Ross Securities, Inc. et al.*, 40 S.E.C. 1064, 1066; *Barnett* v. *United States*, 319 F. 2d 340 (C.A. 8); *Samuel B. Franklin & Co.* v. *Securities and Exchange Commission*, 290 F. 2d 719 (C.A. 9), certiorari denied, 368 U.S. 889.

[8] *Merritt, Vickers, Inc.* v. *Securities and Exchange Commission*, 353 F. 2d 293 (C.A. 2); *Richard A. Holman*, 40 S.E.C. 870. See also *Low Wah Suey* v. *Backus*, 225 U.S. 460, 470–471; *Missouri ex rel. Hurwitz* v. *North*, 271 U.S. 40, 42; *Brown* v. *Macy*, 222 F. Supp. 639 (E.D. La.), affirmed, 340 F. 2d 115 (C.A. 5); *Williams* v. *Zuckert*, 296 F. 2d 416 (C.A.D.C.); *Hyser* v. *Reed*, 318 F. 2d 225 (C.A.D.C.), certiorari denied *sub nom. Thompson* v. *United States Board of Parole et al.*, 375 U.S. 957; *Reetz* v. *Michigan*, 188 U.S. 505. Petitioners do not claim that any evidence or documents they needed were in fact unavailable to them, and we point out that the Commission does have subpoena power, which they could have invoked upon an appropriate showing of need (§§ 21(b) and 15A(h)(1) of the Act, 15 U.S.C. 78u(b) and 78*o*–3(h)(1)).

[9] *Handley Investment Company*, Securities Exchange Act Release No. 7438, p. 3 (October 9, 1964), affirmed, 354 F. 2d 64 (C.A. 10); *Thill Securities Corporation*, Securities Exchange Act Release No. 7342, pp. 12–13 (June 11, 1964); *Nassau Securities Service* v. *Securities and Exchange Commission*, 348 F. 2d 133 (C.A. 2); *R. H. Johnson & Co.* v. *Securities and Exchange Commission*, 198 F. 2d 690 (C.A. 2), certiorari denied, 344 U.S. 855.

tions that the NASD investigator is "normally unavailable" (Pet. 9) at the hearing[10] and that the testimony heard before the NASD is entitled to no weight because it is unsworn and hence lacks the "salutary effect of an oath upon a witness' truthful statement of facts" (Pet. 10).[11]

2. While not disputing the number of sales, the prices charged, and the percentages of mark-up based on contemporaneous costs, petitioners argue that the NASD and the Commission erred in holding in this particular case that the firm's contemporaneous purchase prices constituted an appropriate base upon which to compute the reasonableness of mark-ups in the firm's retail transactions. However, it has been consistently held both by the Commission[12] and the

[10] In fact, here the investigator was present at the proceeding and, as the Commission found, "when during the course of the cross-examination * * * certain questions arose which were deemed appropriate for the investigator to answer, such questions were directed to him" (J.S. 57, 265–266). See *Deviny* v. *Campbell*, 194 F. 2d 876 (C.A.D.C.), certiorari denied, 344 U.S. 826; *Brown* v. *Macy*, 222 F. Supp. 639 (E.D. La.), affirmed, 340 F. 2d 115 (C.A. 5).

[11] Petitioners do not claim that any of the testimony or evidence in this record is untrue. Indeed, the bulk of it consists of their own testimony and their own books. See *Deviny* v. *Campbell*, 194 F. 2d 876 (C.A.D.C.), certiorari denied, 344 U.S. 826; *Brown* v. *Macy*, 222 F. Supp. 639 (E.D. La.), affirmed, 340 F. 2d 115 (C.A. 5).

[12] See, *e.g.*, *Mitchell Securities, Inc.*, 37 S.E.C. 178, 181; *Boren & Co. et al.*, 40 S.E.C. 217, 219–220; *Naftalin & Co., Inc.*, 41 S.E.C. 823, 826–827; *Maryland Securities Co., Inc.*, 41 S.E.C. 836; *General Investing Corporation*, 41 S.E.C. 952; *Norman J. Adams*, 41 S.E.C. 993; *Givens, Marx & Co., Inc.*, Securities Exchange Act Release No. 7332 (June 3, 1964); *Edward W. Stewart*, Securities Exchange Act Release No. 7347 (June 15, 1964); *Samuel B. Franklin & Co.*, Securities Exchange Act

courts that "a dealer's own contemporaneous cost, in the absence of countervailing evidence, indicates the prevailing market price."[13] Petitioners' contention that in the instant case the prevailing market price was represented by their "ask quotation" in the wholesale quotation sheets rather than by their contemporaneous purchase prices was answered by the Commission in a recent case:

> Where a dealer, although regularly in the sheets, sells primarily to retail customers, its "own ask quotation can be a self-serving figure, and to allow its use as a base for computing mark-ups on retail sales to customers would be to countenance a boot-strap operation which would give a dealer unrestricted latitude in setting its inside ask price and therefore the retail prices, and nullify the NASD's fair pricing policy as a protection to investors." [*Langley-Howard, Inc.*, Securities Exchange Act Release No. 7986, p. 6 (October 26, 1966); footnote omitted.]

The record clearly shows that, during the periods in question here, the firm made no sales at all of Unison stock to other dealers and only one sale of National stock (at a price below the firm's ask quotation) to

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Release No. 7407 (September 3, 1964); *Costello, Russotto & Co.*, Securities Exchange Act Release No. 7729 (October 22, 1965).

[13] *Associated Securities Corp.* v. *Securities and Exchange Commission*, 293 F. 2d 738, 741 (C.A. 10); see, *e.g.*, *Samuel B. Franklin & Co.* v. *Securities and Exchange Commission*, 290 F. 2. 719 (C.A. 9), certiorari denied, 368 U.S. 889; *Merritt, Vickers, Inc.* v. *Securities and Exchange Commission*, 353 F. 2d 293 (C.A. 2); *Handley Investment Co.* v. *Securities and Exchange Commission*, 354 F. 2d 64 (C.A. 10); *Barnett* v. *United States*, 319 F. 2d 340, 344 (C.A. 8).

another dealer (Exhibit 2, J.A. 144; Exhibit 6, J.A. 153). Moreover, the Commission has held with respect to low-priced unseasoned securities such as those involved in the instant case that the quotations listed in the "pink sheets" bear little relation to actual bid and asked prices and are often subject to negotiation. *Naftalin & Co., Inc.* 41 S.E.C. 823, 828; *J. A. Winston & Co., Inc.*, Securities Exchange Act Release No. 7334, p. 10 (June 5, 1964); *Costello, Russotto & Co.*, Securities Exchange Act Release No. 7729, p. 4 (October 22, 1965).

Petitioners quote extensively (Pet. 17–21) from the Report of Special Study of Securities Markets of the Securities and Exchange Commission.[14] H. Doc. No. 95, Pt. 2, 88th Cong., 1st Sess., 649–652 (1963). They do not mention, however, that the conclusion of the Special Study Report with respect to securities in which there is little interdealer activity was that (*id.*, p. 652) "to ignore the fact there is no independent market may be to permit markups on an artificial base." Since the issuance of the Special Study Report, the Commission and the courts have reaffirmed the policy of using contemporaneous cost as the basis for determining fair mark-ups.[15]

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[14] The Report was the work of the Commission's staff and of other persons employed to conduct the Study, and the quoted excerpts are chiefly from testimony of witnesses. The Report is not the opinion or decision of the Commission or any other official body.

[15] For example, in *General Investing Corporation*, 41 S.E.C. 952, the Commission said at p. 955:

> The Special Study found that a sole or dominant market-maker is often associated with inactively trading securities attracting limited investor buying interest. In

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted.

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MAY 1967.

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such situations, there are few, if any, sales by the market-maker to other broker-dealers, and the market-maker's costs of purchase frequently represent the only available evidence of the actual prices at which the interdealer transactions are being executed. * * * In such cases, concentration of sales on the retail level and domination of the market by maintaining or increasing a bid would provide a dealer unrestricted latitude in setting its inside offer and therefore the retail prices. A determination on the basis of the firm's own inside offer that the mark-ups realized by it in retail sales were not excessive when other firms are offering at wholesale prices lower than the firm's inside offer would make a sham of the protection intended by the NASD proscription that a member shall not charge unfair prices in principal transactions with customers.

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